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SUMMARY

¶1. (SBU) China presently has in place an interim oil pricing mechanism that will eventually lead to the integration of domestic prices with global prices, according to National Development and Reform Commission (NDRC) Vice Chairman Bi Jingquan, as quoted by media on March 11. Bi's comment caps years of efforts on China's part to keep rising global oil prices and increasing market volatility from harming consumers, rural residents, and oil refiners. A previous oil pricing policy was suspended in 2004 amid a combination of Beijing's concern with the inflationary effect of high oil prices and worries that the policy's mechanics were flawed. The NDRC has subsequently relied on administrative pricing, but this has come at a cost: refinery profitability has vanished over extended periods, leading to a need for subsidies to the oil companies, while consumers and the media have grown increasingly vocal about insufficient price decreases as global oil prices have come down from recent highs. Several of our contacts are familiar with details of the new pricing mechanism to be put in place, and they say the system will guarantee domestic oil refiners a profit while shielding gasoline and diesel consumers from major fluctuations in international oil prices. They view the new mechanism as incorporating elements of market-based pricing but assess the NDRC's approach as still highly controlled overall, with the new system potentially vulnerable to speculation. End Summary.

NEW PRICING MECHANISM IN PROCESS

¶2. (SBU) NDRC Vice Chairman Bi Jingquan was quoted by media on March 11 as saying that China presently has in place an interim oil pricing mechanism that will eventually lead to the integration of domestic prices with global prices. Bi's comments cap years of efforts on China's part to keep global oil price volatility and price hikes from harming consumers, rural residents, and oil refiners. The new pricing mechanism will reportedly derive the domestic Chinese price of oil from a market basket of Brent, Dubai Fateh, and Indonesian Minas prices. (Note: Brent is considered a world oil price benchmark. Dubai Fateh is the established Middle Eastern price for Asia-destined crude oil. Minas is one of seven oil prices that constitute the OPEC market basket price and is a representative Asian price. End Note.) Such an approach coincides with the NDRC's January reduction of the price of refined oil

products by 3-5 percent, suggesting that it may be a part of the "interim" approach that Vice Minister Bi asserts is already in place.

¶3. (SBU) Dr. Zhao Jianping, a Beijing-based World Bank energy analyst, told us that Beijing has finalized the specific pricing formula to be used. The NDRC will most likely initiate the new mechanism when it assesses international oil prices have settled in the USD 55/barrel range. Dr. Wang Zhenzhong, Deputy Director of the Institute of Economics at the Chinese Academy of Social Sciences (CASS), stated that Beijing has not yet enacted the oil pricing mechanism because NDRC officials are still watching international oil prices and assessing whether major prices fluctuations are on the horizon. There is ongoing criticism of the current pricing policy in newspapers such as the China Daily and the Beijing Economic Daily.

OLD SYSTEM AND MARKET: LIKE OIL AND WATER

¶4. (SBU) Beijing's previous pricing mechanism for domestic oil was in use from 2000 to 2004 and relied on a market basket of New York, Rotterdam, and Singapore bourse quotations. The NDRC then used a proprietary formula to make adjustments monthly based on market movements, but fears about possible inflation and slower economic growth from rapidly rising global prices led to suspension of the mechanism, according to our contacts. World Bank's Zhao said that the pricing formula also had mechanical problems that concerned the NDRC. For example, the one-month time lag fueled market speculation, which was evident in hoarding and resulted in periodic gasoline and diesel shortages. Zhao also noted that the previous pricing system linked the domestic crude price to international refined product (rather than crude product) prices, thus incorporating other countries' refining taxes and administrative fees into China's unrefined oil price.

ADMINSTRATIVE PRICE CONTROLS

¶5. (SBU) After suspending the previous system, the NDRC turned to administrative pricing. This also led to hoarding and speculation by China's oil companies, according to K.F. Yan, a researcher at Cambridge Energy Research Associates (CERA). For example, domestic oil companies recognized that in order to protect farmers, the NDRC was unwilling to raise refined product prices until after the spring planting season was completed. According to Yan, oil companies responded by withholding gasoline and diesel from the market until after the price increases had been implemented.

¶6. (SBU) The NDRC thus shielded domestic consumers and farmers from increased international oil prices, but at the expense of Chinese refiners. Sinopec and China National Petroleum Company (CNPC), which together control some 80 to 90 percent of refinery capacity, lost several billion dollars in 2005 and 2006 selling refined oil products in the domestic market: the below-market oil price forced the companies to import oil at international market rates but to sell their refined products at a loss using the administratively set prices. Senior NDRC officials told us the oil companies' losses were as high as USD 20-25 per barrel at the peak of international oil prices in 2006. As a result, the Central Government ended up compensating Sinopec, China's largest refiner, with subsidies of USD 1.2 billion dollars in 2005 and USD 650 million dollars in 2006. (Note: The current exchange rate, 7.75 Chinese yuan per one United States dollar, is used to convert currency figures throughout this report. End Note.)

CONSUMERS GRUMBLE WHILE EXPERTS QUESTION THE SYSTEM
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¶7. (SBU) CASS' Dr. Wang told us that Chinese consumers are increasingly unhappy with domestic gasoline and diesel pricing, having realized that domestic gasoline and diesel prices do not fall in concert with international trends. He stated that Chinese consumers do not understand why they paid less than USD 2.00/gallon

of gasoline when oil prices approached USD 70/barrel in 2005, but now pay USD 2.40/gallon with oil at USD 55-60/barrel. (Note: We have converted Dr. Yang's figures to USD and gallons for clarity. End Note.) Chinese consumers' unhappiness with prices at the pump is leading them to oppose the oil refinery subsidization payments to the oil companies, he said. (Note: Consumer concerns have been reflected and even supported in state-controlled media. End Note.)

¶8. (SBU) Elaborating on Wang's comments, we note that the NDRC has raised China's domestic gasoline prices by 40 percent over the past two years. China's average retail gasoline price, presently USD 2.40/gallon, has in recent months trended lower than the U.S. equivalent, which stands at USD 2.51/gallon, according to March 5 Department of Energy Statistics. China's diesel prices also have increased by 40 percent during the past two years. Chinese consumers are paying approximately 2.00 dollars per gallon for diesel, some 62 cents per gallon less than United States consumers. China's administratively set pricing scheme has thus ensured Chinese consumers did not experience either the volatility or magnitude of price increases that have affected United States consumers during the course of 2005 and 2006.

¶9. (SBU) Discontent about administrative price controls has found its way into government circles as well. Zhou Dadi, former Director General of the NDRC's Energy Research Institute (NDRC/ERI), recently told a China energy investment forum attended by Econoff that it is inappropriate for the Chinese Government to set oil prices and then subsidize China's oil companies. He stated that the Central Government is being too generous to Chinese oil companies at a time when they are earning large profits. CERA's Yan stated that opposition to the subsidies has led some officials to call for an investigation into the legality of the subsidies.

NEW PRICING SYSTEM A RESPONSE TO CRITICISM

¶10. (SBU) The World Bank's Zhao told us that the Central Government began working on the new pricing mechanism in late-2005 in response to the mounting, and often contradictory, criticism from the public, policy circles, and oil companies. Numerous contacts understand the new system will: (1) reflect oil companies' concerns about profitability; (2) link China's oil price to three international crude oil prices: Brent, Dubai Fateh, and Indonesian Minas; and (3) involve more frequent price adjustments, perhaps as often as every

2-3 days. It is still unclear, however, just how the NDRC will set the refining profit for the oil companies.

¶11. (SBU) One international oil executive we met with pointed to two ways to set refining profits -- either establish an automatic profit rate that includes refining margins or rely on a fixed price but ensure that this price moves with market conditions. The international oil executive said that the NDRC should draw upon its experiences in implementing a pricing mechanism in the power sector during the 1980's when choosing which approach to take. During this period, the Chinese Government set a guaranteed profit margin for power producers. This failed to encourage competition resulting in very inefficient production. The executive stated that if the NDRC heeded this lesson, it would set a fixed price for refined products to ensure more competition and more efficient production. Our contacts and other observers, however, generally believe that the NDRC will move towards an automatic profit rate.

TWO KEY CONSTITUENCIES

¶12. (SBU) The World Bank's Zhao said that the Chinese Government is sensitive about cushioning the impact that any pricing system has on taxi drivers and the rural population. CASS's Wang noted that the Central Government has a longstanding policy of providing fuel subsidies to farmers. The government provided farmers fuel subsidies in 2006 when the NDRC increased fuel prices by 17 percent. Wang believes the Central Government will allocate a special subsidy for farmers when the new fuel price mechanism is in place.

He expects that taxi drivers, however, will only receive a small subsidy, perhaps around RMB 100 (approximately USD 13) annually, an amount that will make little difference given the large volume of fuel they consume.

PROTECTING THE GROWING MIDDLE CLASS

¶13. (SBU) Both Wang and Zhao also expect the Central Government to cushion the middle class (i.e., those consumers who have the means to spend enough on fuel to be impacted directly by price changes) from future price shocks through a price stability mechanism. It is Wang's understanding that China's oil companies have agreed with the NDRC that pump prices correlating with USD 50-60/barrel oil make for an acceptable pricing range. The World Bank's Zhao said that he expects the NDRC, in order to shield consumers from rapid price increases at the pump, will reduce oil companies' refining profits if oil moves into the USD 60-65 range. If prices move above USD 65, the NDRC will return to direct refinery subsidization.

SPECULATION MAY REMAIN A CHALLENGE

¶14. (SBU) CASS's Wang said that despite the new pricing mechanism, the perception remains that China's energy pricing system is opaque. This could feed into a new form of market speculation, more frequent pricing adjustments notwithstanding. Thomas Wong, Director of Oil and Gas Research at UBS, stated that there are two extremes in pricing: state-set prices and the free market. A market-based pricing system that exists somewhere in between is always vulnerable to speculators. Speculation on how China will value oil at any given time could lead to increased prices in the international futures markets. Depending on where and from whom China is purchasing oil, increased futures prices could make China's overseas purchases more expensive.

POSSIBLE FUEL TAX

¶15. (SBU) There is ongoing debate about introducing a 4.5 percent fuel tax that would accompany the new oil pricing mechanism. The tax would reportedly fund energy efficiency and conservation initiatives along with basic road maintenance needs, replacing an existing road maintenance fee that car owners pay annually. Such an arrangement is already in place on an experimental basis in Hainan Province. The international energy executive we spoke with stated that a fuel tax is inevitable, but believes it will be sidelined while the NDRC assesses how well the new oil pricing mechanism works. UBS's Wong agreed, arguing that the fuel tax is a medium-term goal, rather than an immediate one for the Chinese Government. The World Bank's Zhao said a fuel tax could be implemented by 2008. A recent World Bank report described a fuel tax as "the instrument of choice to limit car use, vehicle

pollution, and energy intensity in the economy."

COMMENT: A BALANCING ACT

¶16. (SBU) Consumer and rural frustration, hoarding, speculation, and a loss of refining profitability have been among the distortions wrought by China's efforts to date to manage domestic oil prices as their international equivalents have trended upward. What we know of ongoing efforts to reform the system suggests similar headaches may lie ahead, despite some moderate steps towards a mechanism that incorporates more "correct" market information (using unrefined rather than refined prices) and adjusts according to that data more frequently. Rather than aiming for true market based pricing, policy makers appear to be cobbling together a system that protects consumers from price shocks while assuring refiners' profits -- but only as long as global prices stay below USD 65/barrel.

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